

REAL ESTATE DEVELOPERS AND THE FINANCIAL REVOLUTION--
INTEGRATION INTO THE FINANCIAL SERVICES

by .

THEODORE HORTON III

Bachelor of Mechanical Engineering
Georgia Institute of Technology
(1981)

Submitted to the Department of Architecture
in Partial Fulfillment of the Requirements for
the degree of

Master of Science in Real Estate Development

at the

Massachusetts Institute of Technology

September 1987

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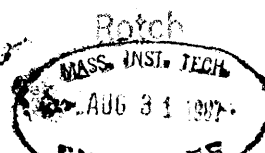
Department of Architecture
August 7, 1987

Certified by

Lawrence S. Bacow
Associate Professor of Law and Environmental Policy
Thesis Supervisor

Accepted by

Michael Wheeler
Chairman
Interdepartmental Degree Program in Real Estate Development



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ABSTRACT

Real estate developers are voracious consumers of capital. One outcome of the deregulation of the financial markets by Congress in 1980 and 1982 was the emergence of the developer owned bank. These banks, chartered under the Federal Home Loan Bank, made primarily acquisition, development, and construction loans for the real estate industry. As a result, developers now had control over their capital source.

This thesis looks at the reasons why this occurred, the objectives of the real estate developers who bought them, whether these objectives have in fact been met, and whether this trend is likely to continue.

The results of this research and case studies show that real estate developers were encouraged to buy banks by; an attractive industry structure, favorable financing, and approval (by the granting of a bank charter) to lend and invest money with the Government being responsible for any downside losses.

Overall, their returns on investment did not meet expectations and they now find themselves involved in a intensely competitive business that derives competitive advantage from technological advance and deregulation but competes all this advantage away. Hence, the structure of the banking industry is now unattractive to real estate companies who might be potential acquirors.

Thesis supervisor: Professor Lawrence S. Bacow

Title: Associate Professor of Law and Environmental Policy

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ABSTRACT	2
ACKNOWLEDGEMENTS	6
1. INTRODUCTION.....	7
A. Purpose of this Thesis	9
B. People in this Thesis	9
C. Organization of this Thesis.....	13
2. THE RESTRUCTURING OF THE BANKING INDUSTRY	15
A. Technological Changes	16
B. The Regulatory Environment	17
C. Emergence of Wall Street	20
D. Winds of Change in the Industry	21
E. New Management Requirements	27
F. Impact on Smaller Banks	28
G. Impact on Real Estate Companies	29
H. Conclusions	31
3. POTENTIAL STRATEGIC BENEFITS OF VERTICAL INTEGRATION FOR THE REAL ESTATE COMPANY.....	33
A. Why Do Companies Diversify?.....	33
B. Vertical Integration for the.....	36
Real Estate Company	

C.	Interrelationships Between Business.....	38
	Units	
a.	Tangible Interrelationships.....	39
b.	Competitor Interrelationships.....	39
D.	Benefits of Diversification for a Real.....	41
	Estate Company Seeking to Gain Control	
	of a Bank	
4.	CROSS CASE ANALYSIS OF DEVELOPERS WHO OWN BANKS	45
A.	Girard Savings Bank.....	46
a.	Background.....	46
b.	The Strategic Issues.....	49
c.	How Girard's Investors saw the.....	49
	Issues	
B.	The Krupp Companies.....	56
a.	Background.....	56
b.	The Strategic Issues.....	57
c.	How Krupp sees the Issues.....	58
C.	Old Stone Bank.....	60
a.	Background.....	60
b.	The Strategic Issues.....	62
c.	How Old Stone sees the Issues	63
D.	Cross Case analysis of the.....	65
	Interrelationships	
a.	The Tangible Interrelationships.....	67
b.	Competitor Interrelationships.....	69

5.	A LOOK TO THE FUTURE.....	71
	A. The Trend for Diversification.....	72
	B. Future Industry Structure	73
6.	BIBLIOGRAPHY.....	76

ACKNOWLEDGEMENTS

This research work was a personal first. But like so many other accomplishments that we say are self-made, it is built upon the strengths of the friendships and professional relationships that provided the genesis of this project and the constant encouragement that hastened it's completion.

Hearty thanks go out to all the willing interviewees. Their insight and judgement were invaluable, as was the time that they donated to this research.

Larry Bacow, who advised me, provided the vision and direction needed to clearly focus on the central questions of this thesis. His patience and amusement as he watched me design and craft this thesis with bent saw and rickety ladder provided motivation to make the finished work as sound and appealing to the reader as possible.

I wish to dedicate this research to those who taught me the meaning of hard work and the sheer joy of learning-- my mother and father.

Introduction

Bankers and real estate developers have always been close associates. To develop real estate, one must have access to large amounts of capital to finance acquisition and construction of property. Commercial banks are the traditional source of such financing. Thus, a developer invariably works very hard to maintain a good relationship with his banker. Similarly, real estate developers often are a bank's best customers. They purchase large quantities of the banker's product-- money-- and typically offer good security for their loans. Thus the developer is an equally important person for the banker.

For years the relationship between banker and developer has been that of supplier and customer. The banker typically would sell money for a fixed period at a predetermined price that was either fixed at the time of the loan or floated with the prime rate (which was predictable). Recently, however, this relationship has evolved from one of customer/supplier to a partnership. Banks commonly seek (and developers offer) participation in the profits of a development as additional consideration for making a loan. As a result, banks today are much more in the development business than they were ten years ago. To be sure, their participation is limited and they do not initiate projects. But make no mistake about it, banks are in the development business.

A more recent phenomenon is represented by real estate companies entering the banking business. Over the past five years, developers throughout the country have either acquired existing thrifts or banks, or obtained charters to start new institutions. While the integration backwards into financial services has been most common in Texas and California, the phenomenon is nationwide in scope. Moreover, it has received lots of attention from the business press. The Wall Street Journal, Institutional Investor, Newsweek, Forbes, Fortune, the New York Times and others have featured articles on developers who have either acquired or started banks.

Congress has also begun to scrutinize this movement. The Barnard Commission has been investigating insider abuse in the savings and loan industry, primarily through fraudulent real estate transactions. 24% of all savings and loan institutions in California are insolvent. Some of these have failed due to bad real estate lending and investment decisions by the owners of these banks.

Purpose of this Thesis

What accounts for this spate of bank acquisitions by real estate companies? Why is it happening now? What are the macro-economic forces behind this movement? What are the micro-economic or strategic forces? What are the potential benefits for a real estate company that acquires a bank? What are the potential problems for both the acquiror and the acquired? How does the insolvency of the FSLIC affect the market for new and acquired institutions? Is the phenomenon likely to continue? How should a real estate company plan strategically for this phenomenon?

The People in This Thesis

This topic is best analyzed by introducing the players and describing the power that they employ in accomplishing their objectives.

Real Estate Developers

The central figure in this thesis is the regional real estate developer. His motivations in wanting to influence the partnership between bank and developer are basic to this thesis. Typically comfortable in the wide-open environment of a deal oriented business, he is not comfortable with regulation and conservative risk profiles.

Such developers are familiar with large risk exposures, large financial transactions, leverage financing, creative marketing, and market research. Prospering in a transaction oriented business that idolizes aggressive growth and value creation, they manage their capital and their people with this identical orientation.

The power that they exert is the capital that they can bring to bear on a transaction. Access to capital is the reason why they have gotten into the banking business.

The banking business has attracted increasing numbers of developers recently. The bank acquisitions have meant that these entrepreneurial, aggressive professionals must now manage the bankers that once sat across the table from them.

Banking Executives/Lending Officers

Traditionally educated in larger commercial institutions, these professionals have surfaced in many of the smaller institutions that developers control. They are familiar with the constantly changing nature of the regulatory process, optimizing investment quality and managing people in regulated environments.

A healthy skepticism is brought to the lending process, a necessary balance to the optimism of the real estate borrower. They are comfortable managing a business where profits are measured in dollars and losses are measured in millions.

The power that successful bank managers bring is the ability to judge the risk exposure of a bank's balance sheet and to optimize the risk/return tradeoff.

The two cultures are quite different. However, some of the developers interviewed for this thesis have banking backgrounds. One, a successful apartment developer in San Diego, is a board member of the Federal Home Loan Bank Board in San Francisco. He started his interview by stating categorically that developers should not be in the banking business.

Federal Regulators/FSLIC and FHLBB Board members

Charged with enforcing the rules that Congress passes on the banking industry, the regulators have the difficult job of policing activity in a recently deregulated system. Their policing actions are partly responsible for the stability and profitability of the system.

The deregulation of the liability (deposit) side of the industry in 1980 led to an interest rate squeeze in the early 1980's for many institutions. To relieve the hemorrhaging of these institutions from negative spread between deposits and the long term low rate mortgages that they held, Congress in 1982 authorized thrift institutions to invest in higher earning (and higher risk) investments such as real estate. Inexperienced management made

bad loans and exposed the banks to huge losses that the FSLIC is now responsible for covering. As a consequence, the FSLIC is technically bankrupt at this time.

In order to meet this shortfall, the regulatory agencies have been seeking capital infusions with the lure of possibly condoning a change in industry structure.

The power that a regulator brings is the ability to change the structure of a business, if not an industry, through its policing efforts.

The regulators interviewed for this thesis reflected frustration in dealing with the 20% of the thrifts that have bankrupted the industry. Their frustration stemmed in part from the poor real estate investments that several developer-owned banks made.

Organization of the Thesis

This thesis work describes how the banking industry has changed, the phenomenon of developers diversifying into the banking industry in the last five years, and then comments on the strategic aspects of this industry phenomenon. It addresses the interplay between cultures and organizational objectives of the two closely associated but very different industries. While not comprehensive, this work will help sharpen the reader in recognizing the changes in industry structure that are taking place and in thinking strategically about them.

The second chapter focuses on changes in the banking industry that have presaged the entry of real estate firms into the banking business. Emerging technologies, deregulation, and the movement by the Wall Street institutions into the banking industry will be described as they affect the barriers to entry and the structure of the industry.

The third chapter examines the motivations and strategic benefits of firms that have pursued diversification into either the banking or real estate business. Current thinking on diversification according to Michael Porter will be covered to provide a theoretical framework for the advantages and strategies of diversification. The stated and observed reasons for buying banks will be examined.

The fourth chapter uses case studies and cross case analysis using the explanation building method to study the reasons and actions of the regulators, investors who wished to use institutions as captive financing tools for real estate investment, and bank management. Our cases cover a San Diego bank owned by real estate developers, a Texas bank that is owned by a Boston syndication firm, and a Rhode Island bank that owns a developer, a real estate services company, and a real estate merchant bank.

The fifth chapter will look to the future--will this continue? How will the trend of investment reflect the current regulatory and insolvency problems facing the banking industry? How does the FSLIC's dire insolvency problem affect consumers and providers of capital? Using analysis developed by Michael Porter, this chapter will outline the competitive forces that influence the industry today.

The Restructuring of the Banking Industry

The banking industry has undergone a revolution during the past ten years. This revolution has occurred on three fronts:

- technology
- the regulatory process
- increasing power of Wall Street.

These forces have combined to significantly reduce the barriers to entry to the industry. The consequences of this revolution have facilitated the entry of real estate companies (and others) into the banking business.

This chapter discusses each of these areas and how they have: lowered the barriers to entry, created different management environments, and created a different industry structure.

We then proceed to discuss the effects of these "winds of change" on bank management, smaller banks, and real estate companies. The new industry structure and what it means for potential acquirors will conclude the chapter.

Technological Changes

Revolutionary developments in the computer industry have reduced greatly the costs of transmitting, processing and storing information. Computing advances have significant impacts on the costs and geographic deposit base of a bank-- technology has restructured the supply side of the industry.

EFTS (electronic funds transfer systems) have lowered the barriers to entry to the banking industry. Depositors can be serviced either electronically or through correspondence banking, eliminating the need for brick and mortar investments in branch banks. Depositors can conveniently access their funds coast to coast, and banks can earn greater returns on funds on account, sweeping excess funds into short-term interest bearing accounts.

These advances in technology have made possible the expanded competition of both the variety of financial services offered by institutions and their geographical market area. A broader range of services can be provided at lower incremental cost through an electronic network. The advent of home equity based credit cards, interest bearing checking, and small amount certificates of deposit (CD's) show the flexibility of an electronic funds transfer system.

The labor costs of gathering and servicing deposits have been cut through replacement by the capital investment costs of computer equipment. Moreover, the capital costs of servicing equipment such

as automatic teller machines, point of sale terminals, and automated clearinghouses are costs that can be shared among banks. Hence, the overall costs of attracting and servicing deposits have decreased.

Technology has also restructured the overhead costs of the banking industry. Changes in the cost structure of producing deposits have left existing banks with outdated facilities at higher overhead costs. Consequently, *de novo* or start-up banks have a significant cost advantage over existing institutions.

The feasibility of operating a bank out of the second floor of an office building, attracting and servicing deposits at much lower cost through a shared electronic branch network means that new banks have a competitive cost advantage over existing banks.

The Regulatory Environment

The most significant effect of deregulation of the banking industry is the competition for deposits. Geographical location is no longer the prime factor in generating deposits-- deposits have become a price (interest rate paid) sensitive commodity.

The next most important effect of deregulation is the lifting of restrictions on the scope of lending and direct investment that a bank can do.

The explicit effect of deregulation on entry and expansion by banks has been minimal. However, interstate banking rules recently enacted in states such as Washington, and the loosened acquisition regulations for troubled banks demonstrates the increasing ease with which banks can branch into different areas. This branching poses increased competition for banks existing in promising areas.

Continued deregulation has not spawned a great increase in the number of banks. The mergers and acquisition activity and the record number of failures have not been accompanied by a large amount of new bank charters. California has only approved a handful of new bank charters since 1984, primarily because of the state's inability to regulate a number of new institutions.

Developers wanting to get a charter and start up a bank have found the process very slow and the regulators exceedingly hesitant. "Regulators are very skeptical of the 'Developer Syndrome'," said a thrift industry consultant. "They have become extremely leery of granting charters to investors with aggressive investment histories (read= real estate) or with aggressive investment objectives."¹

This stinginess on the approval of new bank charters is the result of FSLIC's insolvency-- presently \$7 billion in the red, with estimates of total losses at \$40 billion. FSLIC doesn't need any

1. Vanderburg, Catherine, Consultant, Kaplan Smith and Associates, July 28, 1987

new banks-- what it needs is the private recapitalization of it's troubled ones. The agency is looking hard for new capital infusions-- including real property-- to recapitalize these troubled banks. The FSLIC has encouraged acquisitions of troubled institutions by covering the downside risks and waiving regulatory requirements for a period of time. But this encouragement is only being extended to those who have a track record of running an institution successfully.

The FSLIC also has tightened the capital ratios. Recent capital ratios have been doubled for most institutions, from three to six percent of assets.

Diversification under deregulation has not increased the earnings of the savings and loan institutions. "The most successful thrifts have pursued a simple formula-- they have remained single family mortgage lenders. This allows them to keep the administrative costs down and reduces the risk of surprises popping out of the loan portfolio."²

Emergence of Wall Street

Wall Street has influenced real estate finance by the ability to provide large chunks of capital at low cost. In addition, it has

2. ABA Banking Journal, "Things look up for the Thrifts", pp. 60-63, July 1986

shown an ability to structure this capital in innovative ways. Wall Street is able to package, securitize and service large pools of real estate debt that are structured to meet a client's needs. The significant overhead most firms carry requires a minimum public deal size in the area of \$100 million, however, limiting the type of project that they can take on.

Securitization has changed the risks that banks manage, the availability of capital for mergers and acquisitions, and the amount of capital required to do substantial lending.

Mortgage backed securities guaranteed by GNMA or FNMA allow a bank to become a producer of mortgages, collect the origination fees and then sell the mortgages into the secondary market-- eliminating the interest rate risk that buried many institutions in the early 1980's. Increasingly being securitized are other debt instruments such as car loans, leases, and commercial mortgages. Passing through these notes allows a bank to generate a much higher loan volume with minimal invested capital-- basically recycle it's invested capital to earn higher fees.

The securities markets also make it easier for a bank to raise startup capital or issue subordinated debt as capital. The availability of capital and the efficiency with which it can be placed means that banks have access to increasingly large amounts to grow their institution.

The advent of the high-yield or junk bond market means that there is an additional high return area for the banks to park deposits and earn a spread. Additionally, the widespread acceptance of junk bonds means that they are increasingly being used as sources of subordinated capital for banks.

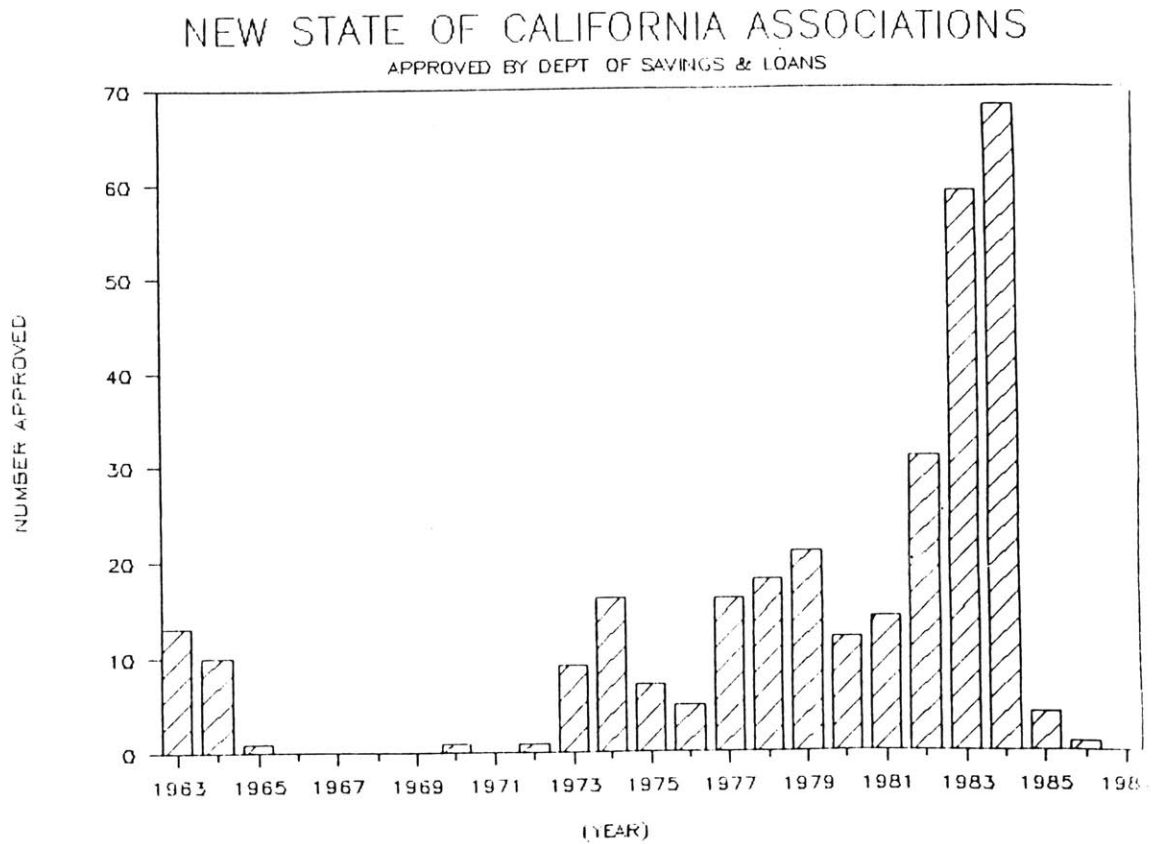
The emergence of non-bank banks as producers of financial instruments has shaped the fee structure and returns of retail financial services. These institutions either produce loans or take deposits, but not both. They have provided intense competition for consumer and business credit, they finance consumer equipment purchases at the point of sale. Securities firms offer accounts that manage cash, credit, securities and free cash, attracting retail deposits. The nonbank institutions that have entered the market are large in size, subject to limited regulation and are highly skillful in their marketing strategy. As the banking industry becomes more deregulated, the importance of marketing skill becomes greater, an area in which Wall Street, but not the banks, have excelled.

Winds of Change in the Industry

The banking industry today looks very different from the industry of twenty years ago. Advertisements in the Wall Street Journal shout out the high rates paid on deposits. The marketing of financial "supermarkets" and personal bankers is slick and sophisticated.

Start ups in the industry are ubiquitous. Chart I shows the number of savings and loan institutions that were started in California during the 1980's. These institutions have the ability to grow rapidly and compete effectively.

CHART I.-- Number of New S&L Institutions in California by Year



Takeovers and mergers have become common. Largely as a result of interstate banking acquisition and competitiveness, banks in desirable areas have been bought at premiums to market value. Strategies pursuing economies of scale are resulting in an increasing amount of consolidation.

Lending has changed substantially. Selling the mortgages into a larger pool that is then securitized has increased the capital available for investment and lowered the cost of funds.

Participation is now common in debt instruments. The emergence of EBA's-- earnings based accounts-- now means that participation may come to the retail banking sector as well.

The 30 year fixed rate mortgage as primary loan instrument is no longer the favored loan structure. Except in the residential market where such loans are guaranteed by the federal government, loans are of much shorter term (5 to 7 years) and with different amortization schedules.

Bullet loans with no amortization of principal are now available.

The liability side of the balance sheet has also changed dramatically. Funds can now be generated through advertisements in the Wall Street Journal and the New York Times. The need for expensive bricks and mortar deposit gathering and servicing institutions are now longer necessary. Chart II is a sample ad

from the Wall Street Journal that advertises for such funds. Funds flow to the highest guaranteed returns available. Consumers are not brand conscious because all savings and loan institutions have Federally guaranteed insurance for all deposits up to \$100,000. In short, the staid, conservative banking business has been transformed in a very short time to a highly competitive, aggressive and entrepreneurial industry.

CHART I-- Brokered deposit advertisement in the Wall Street Journal

PERFORMANCE CD'S

\$90,000 *

6 MONTHS

8.872 YIELD
8.750 RATE


12 MONTHS

9.125 YIELD
9.00 RATE

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New Management Requirements

The stresses of new technology, deregulation, and new competitors have changed the management skills that are required to be profitable. Managing a financial institution's balance sheet in turbulent times requires skillful people. "The regulators place a lot of weight in a bank's track record when looking at allowing expansion or approving a proposed acquisition," said an industry consultant.³

On the value of good bank management, "My advice to any developer who is thinking of buying a bank is-- pay up for good management-- there is no better way to ensure a profitable institution."⁴ "The biggest single mistake we made in buying the bank was not changing management and strategy fast enough-- put knowledgeable people in charge and then depend on them."⁵

.....
3. Vanderburg, Catherine, Consultant, Kaplan Smith and Associates,
July 28, 1987

4. Carter, Thomas., President, Beverly Hills Federal Savings Bank.,
telephone interview, June 30, 1987.

5. Woolley, R.B., President, Girard Capital, Chairman, Girard Savings
Bank; telephone interview, July 14, 1987.

The price sensitivity of deposits requires banks to pay more than they historically had to. To maintain the spread requires both aggressive reduction of overhead and lending on projects that provide higher returns. Knowing where to reduce overhead requires management that knows how to-- without compromising the credit risk of the institution through poor lending policies.

Impact on Smaller Banks

What does all this change mean for a smaller bank? Competition for funds and low risk returns has become increasingly intense. To maintain a comfortable spread between funds coming in and funds going out requires investment into riskier areas.

Deposits can be generated quickly mainly by competing on price. Millions of dollars in deposits can be generated by telephone calls. Although these "hot money" deposits are easily available, a bank will pay anywhere from 50 to 150 basis points more for this convenience.

Loans can increasingly be generated and then sold into the secondary markets, significantly reducing interest rate risk and producing originating and servicing fee income. Fee income is now a higher percentage of a bank's earnings, replacing the percentage spread between deposits and loans that are booked.

Selling these loans into the secondary markets recycles the banks deposits so that new loans can be generated.

Deposits can be used to fund acquisition, development and construction loans. They have been given wider latitude to participate in these loans. These loans carry much higher risk than the typical residential mortgage, risks that can not be hedged against.

Residential mortgages have become very price competitive, increasing the willingness of a bank to take on riskier loans that provide better spreads but also increase the likelihood of surprises in the portfolio.

Surviving the consolidation in this industry means that the small banks need to excel at one of these strategies to survive:

- becoming the low cost producer
- quick service
- assuming merchant banking roles.⁶

Impact on Real Estate Companies

6. Tecca, James, Girard Savings Bank, Telephone interview, June 22, 1987

Real estate companies interested in entering the financial services have found that barriers to entry have been significantly lowered.

Capital requirements are minimal to start up a bank. Capital can be in the form of property or cash and approval has been granted on the basis of financial statements. The well publicized trouble in the S&L industry has meant that many institutions are selling at book value now with no premium to market.

All a real estate company needs is a license and FSLIC or FDIC insurance. This is where the catch comes. Regulators have become increasingly wary of the "developer syndrome" where a bank experiences sky-rocketing growth and then crashes due to credit risk-- with the regulators having to pay the bills. Gaining approvals on charters is much more difficult than anytime in the last five years. "We have been burned by real estate developers. The FSLIC will consider bids for institutions from them...We are under a new boss now...maybe he will change the course that we have chosen...but all I can say now is that developers who would like to have government insurance...may not get it."⁷

Deposit insurance can be obtained either through a start-up or through acquiring a small bank that they intend to grow. The number of new institutions given insurance approval has dropped

7. Butler, John; Marketing Specialist, FSLIC, Washington, DC., telephone interview, July 21, 1987

off sharply in the last few years. The real estate companies that are considering integrating into a bank are doing it by buying existing institutions.

Conclusions

This chapter addressed the changes that the banking industry has gone through in the last five years-- changes that attracted real estate developers to this formerly staid and conservative business.

The business is much easier to enter. Technology and deregulation have combined to lower the barriers to entry. Minimal capital combined with government insurance and a banking license can launch a banking company.

Banks can grow much faster than before. One Texas bank, for example, grew at an annual clip of over 500% in the early 1980's. Limited only by the deposit and capital base, an institution can generate deposits through advertisements in the financial section of newspapers and capital through stock offerings.

The capital markets have become very efficient. Securitization has greatly increased the flows of capital into real estate.

Competition in the banking industry is stiff and is increasing. Present barriers to entry actually encourage new players to enter because of a new banks' lower overhead and ability to grow rapidly.

The industry structure is such that any competitive advantage created by changes in technology or deregulation are lost to competition. Good for consumers, bad for the guys in the banker's suits.

Potential Strategic Benefits of Vertical Integration for the Real Estate Company

In the previous chapter we discussed why the opportunities exist to enter banking today. We concluded with the industry structure in 1987-- deregulated, but very competitive.

This chapter looks at what such a diversification might offer to the real estate company. We start with the theoretical aspects and then apply these precepts to the objectives that developers have for diversifications.

Why Do Companies Diversify?

The philosophy guiding many companies' diversification strategies has changed markedly from the 1970's. Most companies now look for diversification into related industries. More attention is being paid to the "fit" of the diversification into the existing business.

Technology is breaking down barriers between industries and driving them together, particularly those industries that are based on information or electronics technologies. Many building services are now becoming interrelated through shared technologies as an example. As technology is increasing the likelihood of interrelationships between elements, it is also lowering the cost of

utilizing them. The technologies of intercommunication between companies is decreasing the costs of coordinating activities between them.

The ability to enter new markets, to build when conditions are optimum, to overcome barriers to entry cheaper than other potential entrants is what the acquirer seeks through diversification.

Any diversification must meet two tests according to Michael Porter, author of Competitive Advantage, (Free Press, c.1985).

1. Structural attractiveness--the new business must be in an industry that is inherently profitable
2. Competitive position--the profitability of the firm within the industry

To be structurally attractive, an industry must offer opportunities for sustained long term profitability. Not all industries inherently offer equal opportunity to sustain profitability. The profitability of an industry is one key indicator of the profitability of a firm.

Competitive position is the relative profitability of a firm in an industry. It reflects the constant competition that redefines position in an industry. A firm in a very attractive industry may not earn attractive profits if it has chosen a poor competitive position. Conversely, a firm in an excellent competitive position may be in such a poorly structured industry that it still loses

money and further investment will provide little improvement on return.

The diversification must create and sustain a competitive advantage in the real estate industry. Competitive advantage can be gained by interrelationships among business units that create value. This competitive advantage is achieved through two methods:

- changing the industry structure to increase the industry's profitability

- improving their competitive position within the industry.

Companies change the industry structure by capturing profits from upstream or downstream activities and by changing the cyclical nature of their business.

Where in the cycle are the two businesses? The real estate company at the beginning of a building cycle needs a financial firm that is seeking to expand its loan portfolio.

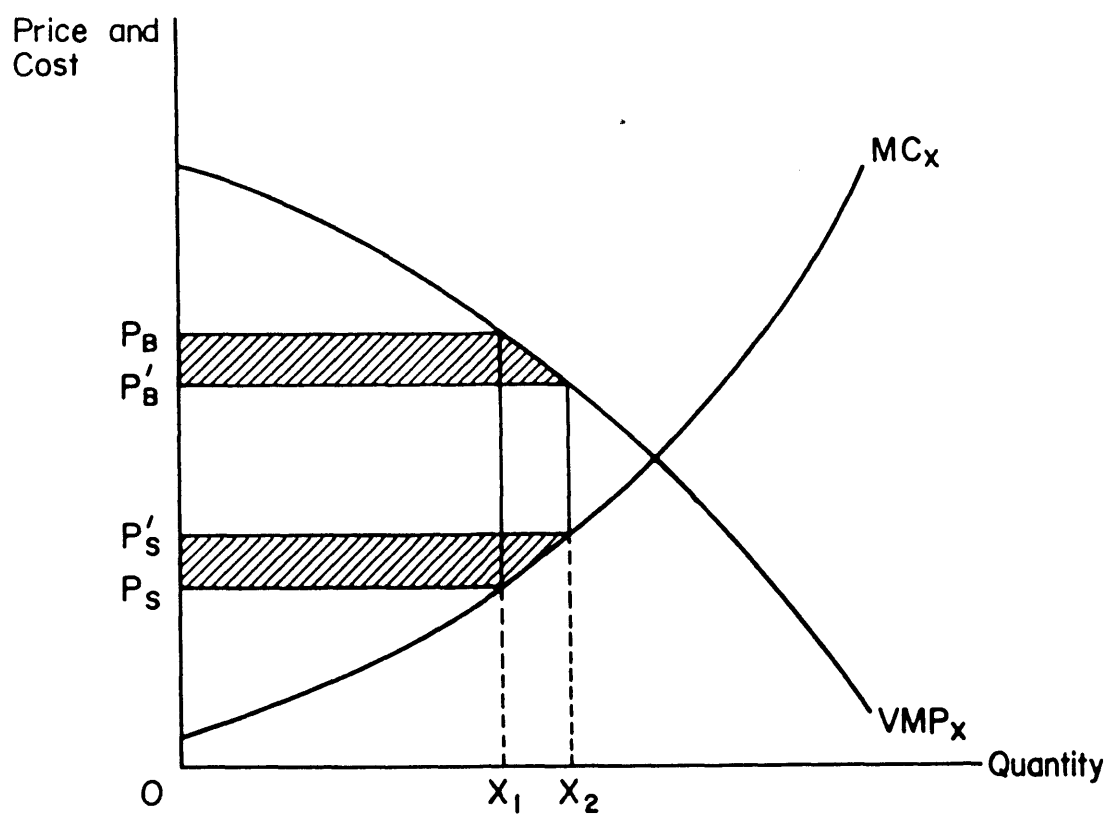
Improving a company's competitive position is achieved by trying to ensure a source of supply for future inputs and to spread overhead through several businesses. This study of advantage through adopting these upstream or downstream business units is called vertical integration.

Vertical Integration for the Real Estate Company

There are two basic methods of allocating productive resources. Outside a firm, price movements dictate production, which is coordinated in a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure is substituted the owner, who directs the quantities and price of production.

The incentive to integrate comes from the transaction costs that are part of every market exchange. Chart III demonstrates the chunk of value that transaction costs take out of the value of the inputs. $P_B - P_S$ is the amount that is equal to the costs of a unit minus the transaction costs. Market equilibrium will result in X_1 of the units being transferred. Profits to the buyer from engaging in this transaction are given by the area above P_B and below the VMP_X curve. Profits to the seller are given by the area below P_S and above the MC_X curve.

CHART III.-- Incentive to Integrate due to Transaction Cost Savings.
 Source: Law and Economics of Vertical Integration and Control, Blair
 & Kaserman



Profit incentive to integrate due to transaction cost savings.

The costs of organizing the transfer are reduced from $P_B - P_S$ to $P_{B'} - P_{S'}$ when the transfer is done internally. $P_{B'} - P_{S'} > 0$ due to organizational costs, but those costs would exist in either case.

The total increase in profits then is equal to $(P_B - P_S) - (P_{B'} - P_{S'})$. There are assumptions that make this not a hard and fast rule; the effect of this integration depends upon the costs of other internal transfers. This optimization problem becomes quite complicated when there are more than two inputs utilized. The complexity of a shared logistical system involving ten inputs may increase geometrically compared to one that has to handle only five.

Interrelationships Between Business Units

Porter defines three types of synergy between business units:

tangible interrelationships

intangible interrelationships

competitor interrelationships

The three types of synergy or interrelationship can occur together. Each type of interrelationship leads to competitive advantage in a different way.

The advantage that the developer should be most concerned with are the effects of tangible and competitor interrelationships. They have the most compelling links to competitive advantage and are easier to implement.

Tangible Interrelationships

A tangible interrelationship between a bank and a real estate company is a function of shared costs in the management of loans, troubled properties and in increasing returns through investment in real estate. It is a function of infrastructure relationships, of shared benefits in finance and talent. These offer a competitive advantage when they are a significant proportion of cost.

The major limitation to the competitive advantage of shared financing is the efficiency of the capital markets. Financial interrelationships are the basis of competitive advantage when accessing capital is a problem (such as in construction loans) or when the credit ratings of the two units are substantially different.

Competitor Interrelationships

Competitor interrelationships are present when a real estate company competes with diversified rivals in more than one business unit. Any competition taken against diversified rivals must consider the entire range of businesses. The competitive advantage depends on the interrelationships that both firms have achieved. These interrelationships bring differing sources of competitive advantage with them.

Rivals with different interrelationships will attempt to shift the nature of competition in the direction that makes its interrelationships more strategically valuable. For example, a developer that has a captive bank provide financing for its deals might tend to shift the building field to where it can offer tenants a quicker turn-key operation or offer builders on its lots guaranteed financing if they buy the developers lots. The competition shifts to a level where it is assumed that financing is provided, thus shutting out all those developers who cannot provide financing. Another aspect of competitor interrelationship is the leverage advantage that banks offer on invested capital.

The essence of the competitive game between firms pursuing different forms of interrelatedness is a tug of war to see which firm can shift the basis of competition to compromise the other's interrelationships, or enhance the value of its own.

Benefits of Diversification for a Real Estate Company

Seeking to Gain Control of a Bank

The benefits of diversification for a real estate company that is interested in gaining control of a bank is in:

- tangible interrelationships

 - increased leverage

 - source of workout fee income

 - access to information on credit markets

 - access to information on leasing markets

- competitor interrelationships

 - generate fee income to moderate real estate cycles

 - access to funds

 - increased leverage

Tangible interrelationships are those that add value to the final product-- availability of second mortgages to a home builder, ability to provide a home equity credit card when a house is sold, etc. The value added by the direct interrelationship is in the areas of financing a project, financing the sale, refinancings, securitization and guarantees on parts of the project. This added value could help to lower the costs of financing and the total project costs.

Another tangible interrelationship is the workout fee income that would come from managing the development and leasing up of projects that the bank forecloses on. Captive development talent

can increase the returns for the bank in risky acquisition, development and construction loans.

Access to information on the credit and leasing markets is more intangible. We cannot define quantitatively how owning a bank may help a developer in structuring better deals. Access to information is only part of the solution; much more important is what a person does with that information.

Competitor interrelationships are the alliances by competitors that change the playing field. Does owning a captive financial institution that will provide 100% financing on demand change the structure of a regional real estate market? Increases in supply in Texas and California have affected all real estate investors-- the lending that the developer-owned banks did structurally changed the market.

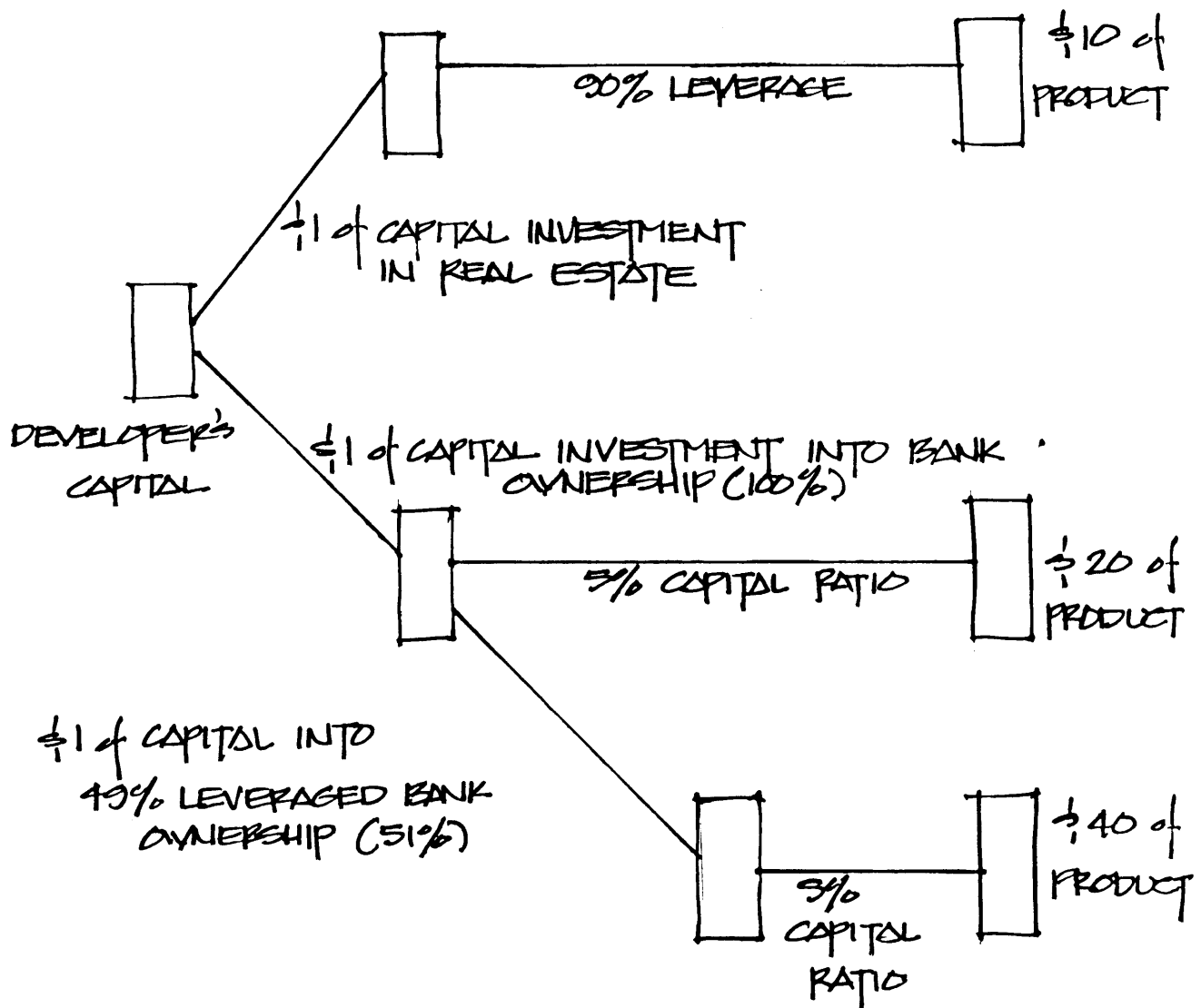
Access to funds when a bank is owned by a capital intensive industry such as real estate means that the market reacts quicker and and more forcefully with this dedicated capital. Windows of opportunity are shorter-- and the overall effect on the market is to increase the pace of development, all other factors being equal. If development is not capital constrained, then it becomes market constrained-- after it has been built and cannot be leased up.

Developing through a savings and loan institution allows a developer much greater leverage. On five dollars of invested

capital, a developer can lend out \$100 on real estate loans. If a developer is merely a minority shareholder, then this leverage is even greater. Chart IV shows the difference developing through a bank can make on the leverage of a project.

The next chapter will look at how several banking/real estate development companies have actually competed with these relationships.

CHART IV.-- Leverage of Original Capital through Bank Ownership



Cross-Case Analysis of Developers who own Banks

We previously looked at the changes in the financial services markets, and the business interrelationships that are the foundation for the recent trend of why developers have bought banks.

We now look at three concrete examples of the real estate company/bank interrelationship, albeit in three different structures.

These companies initially saw the opportunities that deregulation posed and bought institutions to take advantage of these changed markets. They are examples of well-managed institutions that partly through sound management remain profitable in the recently turbulent times in the banking industry. How did they see this diversification? Did they anticipate the problems that they encountered? Did this diversification meet their objectives?

This chapter concludes with a cross case analysis of these three companies. Against the strategic framework that we drew in chapter 3, we will compare the theoretical data with the actual results and draw some conclusions.

Girard Savings Bank

Background

Girard Savings Bank in La Jolla, California is a FSLIC insured institution that does commercial real estate lending almost exclusively. Currently \$200 million in assets, it has grown at 46% per year (averaged over 5 years).

Girard was originally Forty-niner Savings Bank, located in Oakhurst, California, a small town north of Fresno; the bank had about \$30 million in assets in 1982.

In 1983, Forty-niner Savings Bank's management was approached by a group of San Diego real estate investors who were interested in buying their savings and loan institution. This group, headed by venture capitalist R.B. Woolley, wanted to establish a real estate oriented savings and loan institution in San Diego that would take advantage of recent deregulation in the industry. The options to achieve this goal were two: they could stand in line and apply for a charter or they could go out and buy an institution and open a branch in San Diego.

The rush to get into the S&L business was "like a fire sweeping over the plains," said one of Girard's investors, "People saw the money to be made through deregulation."¹

1. Drogin, Steven B., The Drogin Company, Telephone Interview, June 1, 1987.

They found that buying an existing charter was much quicker and also much more certain. There were almost 200 applications for charter in a pipeline three to six months long that had unpredictable results.

The bank was acquired with about \$6 million in cash and the strength of their financial statements. "We purchased this institution very conservatively--all cash and at a price of 20% of deposits."²

A branch of Forty-Niner Savings Bank was opened in San Diego as Girard Savings and Loan. The bank's management was initially maintained and the management environment was a loose, entrepreneurial one. The initial objective was to build the bank through lending and developing in the booming San Diego commercial real estate market. There were no plans to diversify out of San Diego County.

Asset structure problems were uncovered during the first six months of ownership. This along with starting a new location in San Diego with existing management from the Oakhurst location resulted in difficult times for the stockholders. The stockholders were all real estate investors with "capitalistic natures" that did

2. Woolley, R.B., President, Girard Capital, Chairman, Girard Savings Bank; telephone interview, July 14, 1987.

not understand the constantly fluctuating regulatory environment. There were-- as a result-- no unanticipated benefits from the first year of ownership.

In 1984, the president of the bank was replaced by a twenty year veteran of the Bank of America, Mr. James Tecca. He reorganized and instituted policies that controlled the type and amount of lending. The bank's management today strives to reduce overhead to an absolute minimum while continuing to grow. "We carry \$200 million in assets with twenty people. The only way to 'maybe' survive after Wall Street drives all the high overhead banks out of business is to be the low cost producer. Wall Street's momentum into the retail banking business should be scaring a lot of bankers."³

3. Tecca, James, Girard Savings Bank, Telephone interview, June 22, 1987

The Strategic Issues

The issues facing the investor group in 1982 were:

1. Is there money to be made in deregulation? What is the industry structure?
2. How do we take advantage of the recent deregulation of federal and state chartered savings and loan institutions? How should we structure ourselves? What should our competitive position be in this industry?
3. How will this business be a competitive advantage to our real estate business?
4. Who else finds this diversification a competitive advantage? What are the competitor interrelationships that we face? In other words, how is the game going to change? Are we ready?

How Girard's Investors saw the Issues

"We saw that there was money to be made in deregulation--by becoming a niche player in real estate we could participate in the

San Diego real estate boom. Through participating loans, we could own 50% of some of the best deals in the county."⁴

In 1982, the acquisition and start-up activity in California was twice that of 1981. 1983 was twice of that in 1982, with over 60 new state savings and loan institutions. There was a similar meteoric rise for the number of branches of state and federal associations in California. There was over a sixfold increase in the number of branches in 1982 and 1983 compared to 1981.⁵ See Chart III for a graphical description.

Between April 12, 1982 (when the federal savings and loan associations were deregulated) and the fall of 1984, seminars were conducted by consultants and attorneys who obtained charters for banks and savings and loans and told developers and homebuilders that they should own their own moneymaking machines.⁶

4. Drogin, Steven B.

5. Crawford, William J., Savings and Loan Commissioner of California, Proposed Testimony before the Consumer and Monetary Affairs Subcommittee of the House Government Operations Committee of the U.S. House of Representatives, June 13, 1987.

6. Crawford, William J.

The Federal deregulation caused many institutions to change charter from state to a federal charter, resulting in the California Department of Savings and Loan losing 68% of its assessment funds. This prompted the state to liberalize its regulations to allow institutions to make 100% loans and to directly invest in real estate, service corporations and other assets.⁷ The state of California deregulated its institutions in 1983.

Clearly, deregulation offered real estate developers opportunities to generate their own development capital. The decision for Girard was whether they would merely lend or use the bank as developer for additional leverage and protection from downside risk. Girard initially opted to do both. It found the lending much more profitable than the development. Said the president, Jim Tecca, "Development is too unstructured--too entrepreneurial for the people in the banking industry." The bank stopped further real estate development and concentrated on making participating mortgages.

The industry was changing structure rapidly. There was a free enterprise movement at the federal level which stated that "what this industry needs is a free enterprise entrepreneur with expertise and capital to recapitalize the industry and use creative methods to restructure the balance sheets of the savings and loan

7. Crawford, William J.

industry."⁸ It was easier to get into the business, and the investment opportunities were broader than they ever had been.

Real estate expertise that voraciously consumed capital combined with a company that could generate the total amount of capital required for a project with a 3% reserve requirement. The industry structure certainly was attractive--unheard of leverage, ability to raise funds with a phone call, and inexpensive Government insurance on the deposits. The nature of managing in a regulated industry was an unknown quantity, even as "deregulated" as this industry was getting to be.

What was the competitive position within the industry to be? This question took into consideration the bank's present management, the investor's desire to grow the bank and the location of the bank. The bank's center of operations was moved to San Diego as soon as possible. The investors wanted to use the bank to do real estate development because of the leverage advantages and the downside protection they received from FSLIC insurance.

The competitive advantage that they were seeking came from the tangible interrelationship of owning a bank. Although there was no intent of self-deal financing for their own real estate projects, they did intend to use the bank as a source of information on the

8. Crawford, William J.

market and to profit from the real estate boom through participatory financing.

Competitor interrelationships-- other developers who were similarly structured-- created a surplus of money chasing projects in San Diego County. The sky-rocketing growth of other savings and loans fueled an already overheated development market. This oversupply of development funds contributed greatly to the four and a half year supply of office space that is currently vacant in San Diego.⁹ These interrelationships create a real estate environment totally different from five years ago--minimal appreciation, much slower absorption, and with access to capital no longer the critical element in putting a deal together.

The advantage now lies "in the ability to read markets, to create value...asset management is the key. Developers don't need capital, they need development expertise-- to refit, analyze, and redevelop properties, " said one San Diego developer.¹⁰

Girard Savings Bank objectives are now to "maintain our presence in real estate through joint venture agreements with developers

9. Birch, David L. MIT, America's Office Needs: 1985-1995, MIT Center for Real Estate Development, 1987

10. Kruer, Patrick, Patrick Development, Federal Home Loan Bank Board of San Francisco; telephone interview, July 1, 1987.

and to depend on our management."¹¹ The real issue seems to be investment quality, not access to capital. If the bank can provide the information to make superior investment decisions, the stockholders seem to have a competitive advantage.

The stockholders recently participated in the bank's most profitable quarter ever. Diversification among types of real estate investment and lower interest rates led to good spreads in deposits vs. loans outstanding.

Are they looking at buying another bank? No. What have they looked at? Mortgage brokers, title insurance companies-- where the bank does not bear the interest rate risk. "We have been burned by interest rates. We aren't very good at guessing them."¹²

What advice would they give to others looking to do the same thing? "Be very careful of the cultural differences-- they are not compatible. The nature of regulatory agencies is something that developers do not understand."¹³ The president of Girard Savings and Loan said, "Now is not the time for developers to diversify into the banking industry..there are a lot of risks ahead for the

11. Woolley, R.B.

12. Woolley, R.B.

13. Woolley, R.B.

financial services industry. Developers should put their money elsewhere-- perhaps develop sources on Wall Street that will eliminate the middleman."

**The Krupp Companies/Briarcroft Savings & Loan/Briarcroft
Mortgage Co.**

Background

Briarcroft Savings & Loan is a state chartered Texas savings & loan. It was acquired in 1982 by the principals of the Krupp Companies.

The Krupp Companies are a group of Boston based real estate financial service companies that perform syndication, acquisition and management. The bank was acquired by George Krupp, a principal in the Krupp Companies, to participate in the Texas real estate boom of the early 1980's. By owning an S&L, he could significantly leverage his investment in the booming Texas real estate market. Purchase of the S&L was done on a leveraged basis with perhaps 5% down and the rest carried on paper from the parent company.¹⁴ The S&L was acquired with assets of \$100 million and grew to \$750 million in five years. The bank was seen as a development vehicle that could provide significant returns with no risk exposure to the owners. All investment risk was borne by the FSLIC-- the insurer of the depositors' accounts.

Macroeconomic problems in Texas created earnings and profitability problems for many Texas banks. General overbuilding and economic

14. Donovan, Peter, Briarcroft Mortgage Company, telephone interview, June 23, 1987

malaise from the depressed energy industries changed the strategy of many banks from no-risk development plays to workout situations where the main issue is to hold on and try to "keep the bank from hitting the wall".¹⁵

The Strategic Issues

The issues facing the George Krupp in 1982 were:

1. Is there money to be made in deregulation? What is the industry structure? Where is the optimal geographic location for this bank?

2. How do we take advantage of the recent deregulation of federal and state chartered savings and loan institutions? What should our competitive position be in this industry?

3. How will this business be a competitive advantage to our real estate syndication business?

4. Who else finds this diversification a competitive advantage? What are the competitor interrelationships that we face? In other words, how is the game going to change? Are we ready?

The issues facing George Krupp now are:

.....
15. Donovan, Peter

1. How do I recover from the banking problems that are plaguing Texas?

2. How can I minimize my losses with this investment?

3. When should I sell?

How Krupp sees the Issues

The bank's primary objective is to work out of this market cycle and get into a stable growth situation where the bank can be sold into an interstate banking chain. The industry structure has changed significantly from when the bank was purchased. Was there a way of seeing this? There is presently no competitive advantage seen to owning an S&L in Texas. The industry structure is mainly underwater, with about \$3.5 billion in unrealized losses.

The bank has opened mortgage production offices in other states and is working to diversify across several local economies. The bank is also expanding its title insurance operations. The competitor interrelationships sought are to capture fee income related to their single family mortgage lending business.

There are no plans at present to acquire additional banks. "The play is gone. You don't know how bad a bank's portfolio is-- you can't know enough to make a comfortable valuation."¹⁶

The only S&L acquisition activity in Texas at this time is the activity by two prominent Texas investors to rescue some of Texas' most troubled savings-and-loan institutions using private funds and government guarantees. Any recapitalization or "fire sale" will negatively affect the value of those who are not "dragged back to shore" and their position in the industry.¹⁷

16. Donovan, Peter

17. Simon, William E., Wesray Corporation, comments before Federal Home Loan Bank Board of Seattle meeting, July 9, 1987.

Old Stone Development Company/Old Stone Bank
Providence R.I., San Diego, CA., Seattle, WA

Background

In 1971, Old Stone Savings Bank of Providence, Rhode Island, formed a real estate investment trust (REIT) subsidiary with \$5 million of equity capital with the objective of doubling the size of the trust in five years. The decision to go into the REIT business was made because of recent changes in the tax laws that allowed middle income taxpayers to enjoy the investment advantages of real estate trusts.

The trust grew to over \$20 million in three years and then tanked with the general fall of the REIT industry in 1977. The REIT was merged into the savings bank with the tax loss carryforwards used by the bank. Sheltering bank income from working out this bad REIT saved the bank over \$100 thousand in taxes. They proceeded to buy three more with different tranches of preferred stock and execute the same financial play (called a 368C tax free exchange) with each, using the original tax basis-- which was about 140% of the purchase price. Each REIT acquisition accomplished these primary objectives:

- increase their capital base beyond Rhode Island.
- buy real assets at distressed prices
- sheltered bank income through tax free exchanges

-- use experience generated in working out Old Stone's first REIT¹⁸

At this time, the bank restructured. The bank became a subsidiary of Old Stone Corporation, a common stock corporation that acted as bank holding company. The bank made several other strategic acquisitions that penetrated Sunbelt and West coast markets. A consumer finance company in Washington State, a mortgage origination company in Washington State, three North Carolina savings and loan institutions and a Seattle based bank, Citizens Federal, were all acquired within six years. The acquisitions targeted insolvent institutions where financing was provided by the insuring agency and paper issued by the parent bank holding company.

Old Stone negotiated with the regulators, recapitalized these firms, overhauled the management, and then utilized the tax loss carryforwards to shelter the income of Old Stone Bank. In total Old Stone made 19 acquisitions between 1971 and 1987. These acquisitions accomplished these objectives:

-- Old Stone is now part of a 13 state mortgage banking network

-- Changed banking charter to operate under FHLBB

-- Interstate banking operations in RI, WA, and NC

18. Hodgkin, Andrew M., General Counsel, Old Stone Corporation, telephone interview July 14, 1987

-- Deposit bases in three states

Old Stone Corporation currently has a development subsidiary, a real estate advisory subsidiary that specializes in workouts, and a real estate merchant banking subsidiary that generates pools of capital for real estate equity investment.

The Strategic Issues

The issues facing Old Stone management:

1. The industry structure of real estate development companies is one of high risk and high returns. Do we want to enter this industry? What are the interrelationships that can be formed between the bank, the bank holding company and this developer?
2. How do we take advantage of the deregulation of federal and state chartered savings and loan institutions? What should our competitive position be in this industry?
3. How will this business be a competitive advantage to our real estate lending and loan workout business?
4. Who else finds this diversification a competitive advantage? What are the competitor interrelationships that we face? In other words, how is the financial services game going to change? Where do we want to be?

How Old Stone sees the Issues

"Competition in the financial services has gotten brutal. Wall Street has eclipsed a lot of the profitable areas that we traditionally were successful in-- we have to look for other means of generating fee income," said Old Stone's chief of merger and acquisition activity.¹⁹

As the development subsidiary, "we get guaranteed financing through out parent corporation. This saves us 200 basis points in most occasions on all our construction and development interest costs. And that's not all. We can get construction financing without preleasing. In San Diego, where we are involved in a 300 acre mixed use site, we obtain information on the markets that no other developer has access to. You see, we lend to about 50 or 60 developers in the San Diego make. We get information on market trends, leaseup rates, absorption, and valuable information on tenant activity. I don't have access to credit files, but I sit in on all the credit meetings."²⁰

The industry structure of real estate companies is seen by Old Stone Corporation as one with significant interrelationships to the

19. Holbrook, Robert B., Senior Vice President, Old Stone Bank, telephone interview, July 2, 1987

20. Burns, J. Scott, President, Old Stone Development Corporation, telephone interview, June 22, 1987

financial services. Real estate is a business with "tremendous leverage...phenomenal profits...if you can attract people who can manage the risks."²¹

Its risks must be insulated from the bank, however, and this is done by not having the bank finance any of Old Stone's development projects. Financial guarantees are given by the parent company and not the bank. Equity capital comes from either the parent company or from pooled capital. Since the development company is wholly owned by Old Stone Corporation, all profits and fees revert to the parent.

The tangible interrelationships are:

- guaranteed financing without preleasing
- 200 basis point discount on acquisition and construction financing
- information on local real estate markets
- expertise on working out problem projects
- expertise on structuring joint ventures
- securitization of mortgages or leases.

The competitive advantages seem obvious. This structure can create competitor interrelationships that threaten to change the structure of the development industry. The competitor interrelationships are:

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21. Holbrook, Robert B.

- ability to build quicker
- information to adapt product quicker, build to meet market needs better through superior information
- able to lease at lower prices due to favorable financing
- organized source of equity capital

Has Old Stone found the perfect diversification? How do they reconcile the cultural differences?

The cultural differences are managed by the organizational structure. Placing the two cultures under a parent company that appears to recognize the differences is working. A development subsidiary that is able to get favorable financing and also able to get critical information on markets has a significant advantage.

Cross Case Analysis of the Interrelationships

The first step to any diversification is to examine the industry attractiveness. At the time most of these banks were acquired, the industry structure had radically tilted towards a more free enterprise position. The savings and loan industry moved from a highly imperfect market structure to one with intense competitive pressures in less than five years. Potential interrelationships at the time of deregulation made these banks very attractive diversifications.

Interrelationships always involve a cost, because they require businesses to modify their behavior in some way. The costs of sharing an activity such as financing real estate development can be divided into:

- cost of coordination
- cost of compromise
- cost of inflexibility.

The costs of coordination are related to the kind of development, the financing requirements and the risks assigned to each business. For example, a major office tower presents different and often opposed risks to each business.

The costs of compromise mean that projects are performed in a way that may not be optimal for either the developer or the bank. The capital structure, the cost of funds, the preleasing requirements, or the risks inherent in the project all are subject to compromise. The financing of real estate development pits the basic strategies of a risk-seeking developer against a banker with fiduciary responsibilities. The closer these strategies can be coordinated, the lower the costs of compromise. Financing can be designed where the strategies are congruent through merchant banking organizations or parent bank holding companies.

The third cost, that of inflexibility, takes two forms: (1) potential difficulty in responding to competitive moves, and (2) exit barriers. The cost of inflexibility is a potential cost, either having to

respond to a competitor's moves in one of the businesses or ending one of the interrelationships. In the case of the Krupp Company, the barrier to exit is rather stiff, no one is buying Texas savings and loans, because no one can accurately value the loan portfolios.

Potential competitive advantage can stem from what Porter refers to as infrastructure interrelationships. Provision of capital, guarantees, and securitization can be obtained at better cost through a bank than through a real estate company. The capital markets are an efficient market, and these competitive advantages could be less than they are in other related diversifications, such as brokerage, property management, or construction.

The Tangible Interrelationships

These tangible interrelationships demonstrated in each case revolve around leverage, access to financing, access to development expertise, and information on credit and real estate markets.

The successful cases, such as Old Stone Bank and Girard, have organized around these interrelationships. Guarantees on financing, information exchanged about the market and structuring of joint venture agreements all combine to create an interrelationship that is profitable. Old Stone also uses these interrelationships to establish beachheads, such as establishing a funding group that performs real estate merchant banking for the development subsidiary. Girard used the contacts from its board of directors to invest in the San Diego real estate markets.

Krupp, on the other hand, has failed to coordinate the activities of its bank with the other financial services that it offers. The bank has failed to meet its investment objectives, and the company is not looking to acquire another bank at this time. Were the reasons that Krupp entered the field different from the other two cases? Why buy a bank in Texas when the majority of their operations were in New England? Did they analyze what structure their competitors had and how that affected the industry? Hindsight is wonderful in its clarity, but from the limited exposure obtained, it seems that these exploratory questions should have been researched.

What have they realized? All of the cases have mentioned repeatedly that the *cultures* are very different; what makes for a successful real estate developer seldom makes for a good banker. The risks and fiduciary responsibilities, if not clearly outlined, can become overwhelming.

The developers in our cases have recognized that a bank does not allow one to self-finance real estate deals.

Banking has become fiercely competitive, with an industry shakeout that is occurring that will result in a lot of little losers and a few big winners. The profit margins of many savings and loans have improved due to lower interest rates, but the players that rely on real estate development as a significant part of their income take many more risks for their gains.

Real estate is no longer as dependent on capital. The overbuilding that is occurring almost nationwide is a sign that capital is not the problem, but that developers know what to build, where and when are. Today's market is driven by information and political approvals.

Neither Girard or Krupp are looking at buying additional banks. They feel that the money is better spent elsewhere. The financial services diversifications that they are looking into are:

- mortgage brokering
- title insurance/general casualty insurers
- leasing companies
- securitizing leases or mortgages
- "boutique" consumer finance operations

Old Stone is looking at further real estate diversifications that meet their objective of becoming a major regional banking and real estate player. Merchant banking operations to establish a steady stream of development capital; increased development in the areas that Old Stone is lending in, and expansion of their workout branch into Texas are all expansions that they have accomplished recently.

Competitor Interrelationships

What are our case studies' competitors doing? Using Wall Street as a financing source in very large development projects, joint venturing with institutions, joint venturing with communities that

issue bonds to cover part of the cost of development-- the financial alternatives have grown spectacularly in the last several years.

Perhaps it is more illuminating to describe what they are not doing. Buying banks. The intense competitiveness of the industry makes it unattractive to a real estate company, let alone the fact that the regulatory climate is anti-real estate at this time. The forecasted consolidation will again restructure the industry, making it even more competitive. Moreover, there are other diversifications that offer a better competitive advantage to the real estate company.

A Look to the Future

Real estate companies come in all shapes and sizes, and each has a different need for diversification to ensure a competitive advantage. The trend of diversification into the banking industry was seen as a way to capture a source of capital and increase the leverage in a project. Will this trend continue? The trend of diversification, or as Michael Porter calls it, horizontal strategy, will continue. The trend of diversifying into the savings and loan industry? Forget it. It is a business of completely different culture, of completely different structure, and the efficiency of the markets means that the industry has competed away many of its advantages to the consumer.

The savings and loan industry has transformed from an industry in a highly imperfect market setting to one in which there are intense competitive pressures. The key to success in a banking operation today is profitability, but the present industry structure make this almost impossible.

The move into the banking business in the early eighties by real estate companies was a one time shift due to the perceived need by Congress to attract entrepreneurs into the banking business. To recover from the one-sided deregulation and accompanying bath that many institutions took from the interest rate squeeze in 1979 to 1982, Congress wanted these "entrepreneurs" to realign the balance

sheets and make the industry more profitable. This has now changed and the industry is facing major consolidation in the next five years, along with further deregulation.

Developers will find that the FSLIC is in a paradox. The regulators sorely need private capital to inject into the troubled institutions, something that developers can provide; but the previous administration under Chairman Gray was vehemently against any real estate people running institutions that the FSLIC was to insure. Whether the new administration under Chairman Wall takes a different approach remains to be seen. But the fact remains, it is extremely difficult to obtain federal deposit insurance for a new bank now, let alone a new bank that is owned by a real estate company.

As far as a productive use of a real estate company's earnings-- look elsewhere.

The Trend for Diversification

The first step in diversification is to find an industry that is structurally attractive. Are there complementary products or services? Is there a high barrier to entry to prevent competition? Are there regulatory hurdles that we can use to prevent competition? Are there geographic hurdles?

These questions were the ones that were asked in this research and similar ones should be asked in any diversification or acquisition.

Real estate developers should look at diversification as a means of gaining a sustained competitive advantage in the real estate development industry. This industry is a cyclical one however, and what was an optimum diversification in 1982 is probably not an optimum diversification in 1987.

Future Industry Structure

The future structure of the real estate development industry is "towards a regional developer, there are too many risks for a national player...local political knowledge is critical as is the ability to redevelop, and to create value through asset management. A developer doesn't need a bank to do that," said a San Diego developer who is a member of the FSLIC advisory council and the on the board of the San Francisco Federal Home Loan Bank.¹

The future structure of the banking industry will follow the path of a deregulated industry, similar to the communications or airline industry. Firms will consolidate to prevent further erosion of margins. There will be the large national players and the small, specialized players that aim for the areas that were left behind during consolidation. The capital markets will continue to become more globally efficient and the cost of capital will continue to drop. A comparatively messy time to be in the banking business.

1. Kruer, Patrick, Patrick Development, Federal Home Loan Bank Board of San Francisco; telephone interview, July 1, 1987.

Future structure in all industries will reflect the country's transformation from an industrial society that is short of capital into a society that is flush with money. "In an industrial society, capital is a scarce resource, but in today's information society, there's plenty of capital," said a prominent investment banker. On why interest rates were still high, he blamed volatility.² Volatility and market cycles will be an increasing part of future structure in the real estate development industry, affecting vacancy rates, refinancings and eventual sale of property. Project financing does not seem to be the challenge that it once was.

So what are the challenges that will determine competitive advantage? An informal poll of developers will tell you that the optimum leasing of a project is the most important factor in the success of a project today. Leasing and asset management. Providing the best service possible to tenants is essential to sustaining competitive advantage.

Moreover, they need to make interrelationships that will give them this information before their competitors get it. Service to the client-- John Naisbett described it as the "high touch" in the high tech transformation that we are going through-- is one of the distinguishing competitive advantages that may make a difference..

2. Forbes, "A chat with Michael Milken", July 13, 1987.

The continuing momentum of the high tech-high touch age that John Naisbett talked about is influencing the capital investment patterns and the structure of the development industry.

The new tax law has changed the amount of development that is occurring. It is a force that has changed the structure of the real estate industry. This change must be understood in order to establish a sustainable competitive advantage.

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